CORPORATE CONTROL IN EMERGING MARKETS: THE NON-LINEAR DYNAMICS OF FOREIGN BOARD INVOLVEMENT

Yunita Anwar *, Martin Mulyadi **

* Corresponding author, School of Business, Shenandoah University, Winchester, USA
Contact details: Shenandoah University, 1460 University Drive, Winchester, VA 22601, USA
** School of Business, Shenandoah University, Winchester, USA

Abstract

This study examines the complex dynamics of foreign board membership in corporate governance within 266 family-owned corporations in Indonesia and Malaysia. By employing multiple regression analysis, we have determined a turning point in the level of foreign board representation. Once this threshold is surpassed, the advantages of governance start to diminish, indicating the necessity for a more balanced and diverse board composition. Surprisingly, the presence of women on corporate boards did not have a significant effect on governance practices. The findings indicate that although foreign expertise might be advantageous, relying too much on it can have negative consequences. These observations encourage a reassessment of the makeup of boards in developing economies, suggesting areas for further investigation into governance methods in different types of organizations and cultural contexts.

Keywords: Corporate Governance, Family-Owned Corporations, Board Composition

1. INTRODUCTION

Corporate governance is a fundamental aspect of any corporation’s operations, but its significance is amplified in the context of family-owned corporations. Due to their unique ownership and management structures, these corporations, particularly in emerging economies like Indonesia and Malaysia, confront unique challenges in maintaining effective corporate governance. Our research explores this area, contributing to both the theoretical and practical comprehension of corporate governance in these contexts with valuable insights.

The significance of board composition in corporate governance practices is a central focus of our research. Specifically, we analysed the effects of foreign boards and gender diversity. Although the potential benefits of board diversity are widely acknowledged, the optimal board composition for effective corporate governance remains a controversial topic. Our study seeks to address this research gap, particularly in the context of family-owned corporations in Indonesia and Malaysia.

By revealing the nonlinear relationship between the presence of foreign boards and corporate governance, our research makes significant contributions to theory. Existing theories frequently postulate a positive association between these two variables; this finding expands on that notion. We found that while the presence of foreign board members generally improves corporate governance practices, this effect plateaus and then declines as the proportion of foreign board members increases.

From a practical standpoint, our research provides important insights for family-owned corporations in Indonesia and Malaysia, indicating that while a foreign presence on the board is desirable, a balance is necessary to prevent governance issues associated with excessive foreign influence. Moreover, our findings provide policymakers...
and stakeholders in these economies with nuanced guidance, thereby encouraging better governance practices and, ultimately, more sustainable and successful businesses.

Lastly, our research provides a foundation for future studies in comparable contexts or different types of corporations. The discovery of additional factors that affect the optimal level of foreign board participation could further improve corporate governance practices. Extending comparable studies to additional geographic regions would also help generalize our findings.

This research expands on the fundamental understandings of corporate governance dynamics provided by Tricker (2009, 2012), Berle and Means (1932), and the critical assessments of the effectiveness of governance mechanisms in various geographic contexts emphasized by Claessens and Yurtoglu (2013). It not only adds to the academic discussion but also provides practical advice for stakeholders in emerging markets. The intricate awareness of the complex dynamics of foreign board involvement offers a substantial advancement in our understanding of good governance structures, reflecting the concerns expressed by Cadbury (1992) on the equilibrium between directorial responsibilities and shareholder participation. Our research suggests that it is important to approach the inclusion of foreign board members in Indonesia and Malaysia with caution and careful planning. This aligns with the governance issues and changes addressed by Globerman et al. (2011) and Mitton (2002).

This research explores the intersection of theoretical development and practical application, emphasizing the important relationship between foreign board influence and the effectiveness of governance in family-owned firms. By doing this, it not only enhances academic discussion but also provides practitioners with the necessary knowledge for sophisticated governance frameworks in comparable situations.

The rest of this paper is structured as follows. In Section 2, we provide a literature review, describe the research methodology in Section 3, analyse and discuss the results of our empirical analysis in Sections 4 and 5, and present the conclusions of our research in Section 6.

2. LITERATURE REVIEW

In the early 1980s, the term “corporate governance” rose to prominence (Tricker, 2009, 2012). Tricker (2012) explains that corporate governance issues arise when a corporation’s proprietors delegate operational control to a third party. Berle and Means (1932) recorded the expanding tendency of more powerful managers of corporate day-to-day operations as the number and geographical distribution of shareholders increased. In the 1980s, a series of major corporate scandals and evidence of director power abuse led to the emergence of “corporate governance” as a significant topic.

The Cadbury Report was published in the United Kingdom in 1992. It defined corporate governance and outlined the roles of directors and shareholders: “Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meetings” (Cadbury, 1992, para. 2.5). However, due to differing opinions, there is no commonly acknowledged definition of corporate governance (Aguilera et al., 2015; du Plessis et al., 2011).

Despite the fact that many countries had adopted corporate governance principles by the mid-1990s, a new round of corporate scandals emerged in the early 2000s. Enron was the greatest and most well-known corporate failure in the United States. The peculiarity in Enron’s case was that the organization collapsed amid charges of fraud and director abuses despite the fact that the company had fulfilled most corporate governance principles (Tricker, 2012). Among the early 2000 scandals were WorldCom (the United States), Marconi (the United Kingdom), HIH Insurance (Australia), Parmalat (Italy), and Vodafone Mannesmann (Germany). Following these occurrences, there has been a quick shift in corporate governance procedures around the world (Claessens & Yurtoglu, 2013; Zalewiska, 2014). This transformation in corporate governance practices and structures has occurred across all countries and models, including the Anglo-Saxon and continental European models.

The variations in corporate governance practices and regulations across different countries can be ascribed to the heterogeneity of control structures, the timing of corporate governance reform initiatives, and the varying degrees of enforcement (Al Farooque et al., 2007; Al-Malkawi et al., 2014; Kim & Lu, 2013; Martynova & Renneboog, 2011). The literature presents divergent perspectives on the suitability of different corporate governance models for various countries (Carney et al., 2009; Globerman et al., 2011; Khanna, 2000).

2.1. Corporate governance development in Indonesia and Malaysia

The 1990s Asian financial crisis served as a catalyst for substantial corporate governance reform in the Asian region. Numerous scholars assert that the crisis can be predominantly attributed to suboptimal corporate governance practices, institutional weaknesses, and policy inadequacies (Das, 2001; Globerman et al., 2011; Johnson et al., 2000; Mitton, 2002). In addition, it is worth noting that during that period, Asian corporations exhibited a prevalent presence of subpar disclosure practices, lack of transparency, and ineffectiveness in board practices, as highlighted by the Asian Development Bank (ADB, 2014) and the Organisation for Economic Co-operation and Development (OECD, 2014).

According to Dearden (2003), aid donors have the potential to make significant contributions towards enhancing corporate governance practices in developing nations. In Indonesia, the nation’s dedication to upholding its obligations to the International Monetary Fund (IMF) in the aftermath of the 1997 Asian financial crisis has
been a significant catalyst for the advancement of corporate governance practices within the country. Indonesia, being a civil law jurisdiction, adheres to the dual board structure, a prevalent model in corporate governance. This structure encompasses two distinct boards, namely the "Management board" and the "Supervisory board," each serving different functions and responsibilities. The role of the management board can be likened to that of management in the single board system, while the role of the supervisory board can be compared to that of the board of directors in the single board system (Gul & Tsui, 2004; Wulandari & Rahman, 2004).

In line with the experiences of other nations impacted by the 1997 Asian financial crisis, Malaysia also witnessed the emergence of concerns regarding corporate governance practices subsequent to this crisis. The evolution of corporate governance in Malaysia was not significantly influenced by external entities, unlike the case of Indonesia where the IMF played a role. This distinction arises from the fact that Malaysia did not receive financial assistance from donors during the crisis, as highlighted by Gomez (2004) and Islam (2001). This reform was instigated based on the government’s belief that the crisis was primarily attributable to deficient corporate governance practices, thus necessitating corporate governance improvement for effective corporate restructuring (Alnasser, 2012).

2.2 Theoretical framework

Much previous research in corporate governance has extensively relied on agency theory as a foundational framework for explaining and understanding corporate governance practices (Aguilera et al., 2008). According to Dalton et al. (2007), agency theory has a historical precedence over other theories and continues to be the prevailing perspective in corporate governance research.

The agency theory posits that a corporation can be conceptualized as a legally recognized entity that is owned by a principal, who in turn delegates authority to an agent to manage and oversee the operations of the corporation in their stead. The occurrence of agency problems can be attributed to a fundamental misalignment of interests between the principal, who is typically the owner or shareholder of a corporation, and the agent, who assumes the role of managing the corporation’s day-to-day operations (Jensen & Meckling, 1976). The agency theory research primarily centers around the identification and resolution of agency problems. The board of directors, as custodians of shareholder interests, assumes a pivotal role in corporate governance by serving as a primary mechanism for monitoring agents. This function is crucial in managing agency problems, as highlighted by Aguilera and Jackson (2010), Dalton et al. (2007), Filatotchev et al. (2013), and Tosi (2008).

The corporate governance landscape in Indonesia and Malaysia has been distinguished by a notable prevalence of family ownership, as highlighted by Claessens and Fan (2002). One of the primary issues arising from concentrated ownership is the potential for controlling shareholders to prioritize their own interests, potentially leading to a detriment in corporate performance and the interests of minority shareholders (Claessens & Fan, 2002; Young et al., 2008). The study conducted by Chen et al. (2011) provides evidence suggesting that formal corporate governance mechanisms may not be effective in addressing significant issues within an emerging economy with concentrated ownership.

In contrast to other forms of corporations, family-owned corporations exhibit a relatively lower prevalence of Type I agency problems, while concurrently encountering more pronounced Type II agency problems, as evidenced by the findings of Ali et al. (2007). Type I agency problems arise as a result of the inherent divergence between ownership and management in corporate governance structures. On the other hand, Type II agency problems arise due to the existence of conflicts between controlling and non-controlling shareholders within the same corporate framework. Family-owned corporations are confronted with a heightened level of Type II agency problems due to the pronounced concentration of ownership and the consequential control exerted over the board of directors.

This study aims to examine the dynamics and intricacies of family-owned corporations within the context of Indonesia and Malaysia. In accordance with the agency theory, which posits that the board of directors plays a crucial role in corporate governance, this study aims to examine two key variables related to board composition.

The adoption and adaptation of corporate governance guidance and codes in Indonesia and Malaysia primarily draw from foreign countries. Consequently, it is anticipated that the presence of foreign boards play a substantial role in shaping corporate governance practices in both countries.

According to Phillips and O'Reilly (1998), it can be argued that the inclusion of diverse members on corporate boards holds the potential to exert a positive impact on corporate governance practices. This study undertakes an examination of gender diversity within corporate governance structures, with the aim of exploring its potential impact on corporate governance. In a study conducted by Bear et al. (2010), evidence has emerged indicating that the inclusion of women directors within corporate boards can exert a substantial influence on the integration of socially responsible and ethical considerations into the strategic decision-making processes of organizations. In this context, it is anticipated that the presence of women on board can potentially yield an indirect influence on the implementation of corporate governance mechanisms and principles.

This study employs the corporate governance score developed by Sawicki (2009) as a metric to assess the corporate governance practices. She undertook a comprehensive investigation on the subject of corporate governance in the Southeast Asian region. As a result, she formulated a set of nine criteria that can be employed to evaluate the corporate governance practices.

3. RESEARCH METHODOLOGY

The research sample comprises family-owned corporations within the top 200 publicly listed corporations in both Indonesia and Malaysia.
The utilization of market capitalization as a metric has been employed to identify the top 200 corporations that are publicly listed in both the Indonesian and Malaysian markets, and our dataset comprises a total of 266 family-owned corporations. The data contains a variety of company characteristics and board composition-related variables. Our dependent variable is the corporate governance (CG) score, which is the primary variable of interest. Foreign board percentage (FBP), women in board percentage (WBP), corporate size (natural logarithm of total assets — LNTA), and a dummy variable for Indonesian corporations (IDN) are the primary independent variables.

To determine the effect of independent variables on the CG score, we employed multiple regression analysis. The model includes interaction terms to account for the combined effects of certain variables, as well as squared terms to account for the possibility of nonlinear effects. The model's specifications are as follows.

\[ CG = \beta_0 + \beta_1 FBP + \beta_2 WBP + \beta_3 LNTA + \beta_4 IDN + \beta_5 (FBP \times IDN) + \beta_6 (WBP \times LNTA) + \beta_7 (FBP^2 + WBP^2 + LNTA^2) + \epsilon \]  

(1)

We then set Eq. (3) equal to zero:

\[ \beta_1 + 2\beta_7 FBP = 0 \]  

(4)

We then solve Eq. (4), solving for FBP provides us with the value of FBP at the turning point as follows:

\[ FBP = \frac{-\beta_1}{2\beta_7} \]  

(5)

### 4. RESEARCH RESULTS

Our empirical analysis investigated the influence exerted by board composition on the corporate governance of family-owned corporations that are publicly listed in the countries of Indonesia and Malaysia. Multiple regression analysis was employed to examine these, and a series of robustness checks were conducted to ascertain the reliability of the results.

The findings of our multiple regression model, as depicted in Table 1, incorporate a comprehensive analysis of various factors concerning corporate governance. These factors include the percentage of foreign board members (FBP), the percentage of women serving on the board (WBP), the size of the company (LNTA), a binary variable denoting Indonesian companies (IDN), interaction terms (FBP × IDN and WBP × LNTA), and squared terms for each variable to account for potential non-linear relationships.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Coefficient</th>
<th>Standard error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Const</td>
<td>-8.7732</td>
<td>2.868***</td>
</tr>
<tr>
<td>FBP</td>
<td>3.8449</td>
<td>0.931***</td>
</tr>
<tr>
<td>WBP</td>
<td>-2.7572</td>
<td>2.713***</td>
</tr>
<tr>
<td>LNTA</td>
<td>1.4818</td>
<td>0.279***</td>
</tr>
<tr>
<td>IDN</td>
<td>0.4129</td>
<td>0.215***</td>
</tr>
<tr>
<td>FBP × IDN</td>
<td>0.2061</td>
<td>0.885</td>
</tr>
<tr>
<td>WBP × LNTA</td>
<td>0.1244</td>
<td>0.122</td>
</tr>
<tr>
<td>FBP*</td>
<td>-0.5192</td>
<td>2.018***</td>
</tr>
<tr>
<td>WBP*</td>
<td>0.5162</td>
<td>2.047</td>
</tr>
<tr>
<td>LNTA*</td>
<td>-0.0332</td>
<td>0.007***</td>
</tr>
<tr>
<td>R-squared: 0.490</td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-statistic: 37.55***</td>
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**Note:** ***,** significant in 1% and 10%.

Based on the findings presented in Table 1, it is evident that the presence of a foreign board (FBP) is positive and statistically significant in 1%. The empirical evidence suggests that the inclusion of foreign board members has the potential to enhance corporate governance practices within...
corporations. The empirical findings reveal a noteworthy observation wherein the FBP variable exhibits a negative coefficient that is statistically significant at the 1% level of significance. This observation suggests the presence of a non-linear relationship, wherein the influence of an increased number of foreign board members on corporate governance practices exhibits diminishing returns as the levels of foreign board participation reach higher thresholds.

Upon applying Eq. (5), it has been determined that the presence of a foreign board experiences a significant inflection point at an estimated value of approximately 0.295. The findings of this analysis indicate that there exists a potential association between the addition of foreign board members and the improvements of the corporate governance practices, up to a threshold where the foreign board percentage (FBP) reaches approximately 29.5%. Upon reaching that threshold, the incremental impact of adding foreign board members on corporate governance practices begins to wane, and there exists a possibility that further increases in FBP could yield adverse outcomes for CG.

5. DISCUSSION

The empirical evidence derived from our research indicates that the inclusion of women on corporate boards (WBP) does not exhibit a statistically significant relationship with corporate governance practices within the framework of this particular model.

Moreover, it is noteworthy to highlight that the coefficient of LNTA, which represents corporate size, exhibits a positive and statistically significant relationship. This finding implies that larger corporations generally exhibit superior corporate governance practices.

Additionally, our analysis reveals that the coefficient of IDN, which represents Indonesian corporations as a dummy variable, exhibits a positive association. However, it is important to note that this association only achieves statistical significance at the 10% level.

The statistical analysis reveals that the coefficients associated with the interaction terms (FBP × IDN and WBP × LNTA) do not exhibit statistical significance. This implies that the interaction effects may not hold substantial importance within our model.

Our findings have important implications for both theory and practice, adding to the current discussion on corporate governance, particularly in family-owned corporations. The study expands on Tricker’s (2009, 2012) works, emphasizing the premise that corporate governance difficulties arise when operational authority is ceded to a third party. The consequences of this delegation become increasingly visible in family-owned corporations, where the presence of a foreign board becomes an important indicator of corporate governance quality.

In our research, we discovered that the presence of a foreign board has a non-linear impact on corporate governance in family-owned corporations. This is consistent with Berle and Means’ (1932) claim about managers’ critical role in controlling day-to-day operations. However, it broadens the discussion by demonstrating that a certain level of foreign board can improve corporate governance, but that above a certain point, it can cause problems due to control concentration.

In practice, this non-linear relationship provides critical insights for family-owned corporations in Indonesia and Malaysia. It suggests that, while foreign presence on the board is desirable, there is a need for balance to avoid governance concerns associated with excessive foreign influence.

Our study addresses a key gap in the literature by investigating the impact of foreign boards on corporate governance in family-owned corporations in Indonesia and Malaysia, a context that has received little attention. Despite these contributions, our work also points to future research directions. Understanding the factors that influence the appropriate level of foreign board, for example, could add to our understanding. Extending comparable studies to other geographical locations or different sorts of organizations would also aid in generalizing our findings.

Although our findings are robust, there are certain aspects of our study that warrant additional examination and discussion. Our research has found that there is a non-linear link between foreign board membership and corporate governance. However, this relationship can be affected by elements that were not completely investigated in this study. The findings observed could be strongly influenced by variables such as the specific functions and competence of foreign board members, their country of origin, and the international market dynamics throughout the study period. Hence, the definitive determination of the ideal threshold established for foreign board membership may be contingent on the specific circumstances, which our model may not comprehensively consider.

Moreover, the absence of a statistically significant relationship between the presence of women on corporate boards and governance practices gives rise to other possibilities for disagreement. The root causes for this lack of linkage warrant thorough investigation. The existence of potential cultural differences in corporate leadership between Indonesia and Malaysia, as well as the likelihood that the current governance processes may not accurately quantify the influence of gender diversity on board effectiveness, are areas of disagreement. One may also argue that although the inclusion of women on boards may not have a direct impact on governance scores, it could potentially influence other areas of corporate performance or ethical behaviours, which were not the main focus of this study.

In addition, the fact that our study specifically examines family-owned corporations with the highest market capitalization may limit the extent to which our findings may be applied to other contexts. The corporate governance practices of smaller family-owned corporations may vary considerably, indicating that our findings may not be universally relevant to all family-owned corporations.

Finally, our findings have important implications for the theoretical understanding and practical application of corporate governance. Our findings contribute considerably to the discourse on corporate governance in family-owned corporations and lay the way for future research in this area by investigating the non-linear relationship between foreign boards and corporate governance.
6. CONCLUSION

Our research on family-owned corporations in Indonesia and Malaysia has yielded useful insights into corporate governance practices, with a particular emphasis on board composition. We identified a non-linear association between the proportion of foreign board members and corporate governance practices. While the presence of foreign board members usually improved corporate governance procedures, this effect showed declining returns as foreign board involvement increased. This tipping threshold was anticipated to be around 29.5% FBP.

In our model, contrary to some expectations, there was no statistically significant association between the percentage of women on the board and corporate governance practices. However, we discovered that larger corporations have better corporate governance practices on average. Indonesian corporations, represented as a dummy variable in our model, exhibited a positive association with corporate governance practices, although this was only statistically significant at the 10% level.

Our research makes a substantial contribution to the discourse on corporate governance in family-owned corporations, particularly in Indonesia and Malaysia. By revealing the non-linear relationship between foreign board members and corporate governance, we have provided these corporations with crucial insights. Our findings indicate that while the presence of foreign board members is desirable, a balance is required to avoid governance concerns associated with disproportionate foreign influence.

This research contributes to the theoretical understanding and practical application of corporate governance, thereby encouraging future research in similar contexts or with organizations of different types. Understanding the factors that influence the appropriate level of foreign board participation could aid in the improvement of corporate governance practices.

Although our study has made valuable contributions to the comprehension of corporate governance in family-owned corporations in emerging markets, it is not exempt from constraints. A major limitation is the dependence on quantitative data obtained from the top family-owned corporations in Indonesia and Malaysia, based on their market capitalization. However, this data may not accurately represent the corporate governance practices of smaller family-owned corporations in these countries. Moreover, the omission of qualitative elements, such as the influence of culture and society on corporate governance, offers an opportunity for additional investigation. The immutability of the data also restricts the capacity to capture the fluctuations in governance practices over time, especially in reaction to swift economic developments and policy reforms.

In the future, researchers could use a longitudinal method to gain a deeper understanding of the timing and progression of changes in corporate governance. Examining the impact of foreign and female board members using a more detailed method, such as conducting case studies or interviews, could yield more comprehensive and qualitative findings. Furthermore, broadening the research scope to encompass a diverse range of family-owned businesses with varying sizes and market exposures could improve the applicability of the results. Furthermore, it is possible to further explore the cultural intricacies that impact corporate governance in many emerging countries outside of Indonesia and Malaysia. This entails analysing the way in which these local elements interact with global governance standards.

In conclusion, corporate governance is a complex process that is influenced by a multitude of variables. The composition of the board is crucial in determining the effectiveness of these practices, particularly in Indonesian and Malaysian family-owned corporations.

REFERENCES


